

## Essential Utilities Inc. (WTRG): Relative optimism to concerns on asset mix - investor feedback from our upgrade to Buy (add to CL)

**After our October 19 note upgrading regulated water utility WTRG to Buy (on CL), we received a wide range of investor feedback** on both sides of the aisle, with some in agreement with the attractive relative valuation and robust long-term growth potential, while others remain concerned about the company's water/gas utility profile from an ESG perspective, along with the market's increasingly negative view on the terminal growth rate for gas demand due to electrification.

**We highlight below the main discussion points from our investor conversations** on the WTRG upgrade:

- 1. Some investors see WTRG as a "show me" story**, despite attractive relative valuations, per their view that the PA-based Peoples Gas utility acquisition diluted its status as a pure-play water utility and did not represent the best strategy for value accretion. That said, they are encouraged by management's commitment to increase its 70% water profile (by earnings) through continued water system acquisitions, which investors view as a higher multiple business that they agree is undervalued at current valuations.
- 2. What could improve gas utility valuation multiples?** While investors agreed that WTRG should trade at a discount to pure-play water peers given its exposure to a gas utility, they believe a portion of the company's multiple compression is attributed to the increasingly negative view on gas utilities' terminal growth rate from the electrification theme. They acknowledge that Peoples Gas' majority exposure to gas-friendly Pennsylvania and 10+ year of growth through infrastructure replacement investments (without reliance on new customer connections) should support a premium valuation versus gas LDC peers; however, they remain concerned that continued market pressure on this segment could weigh on WTRG's overall valuation longer than expected.
- 3. Investors wonder whether WTRG could continue to maintain its overweight position among ESG funds**, with the stock still ranking as a top 20 relative overweight per our GS SUSTAIN team data. With ESG fund flow continuing to increase, the funds' perception of WTRG's 30% gas exposure remain key to closing the valuation gap versus American Water (AWK, Buy), the only other large-cap water utility that still maintains its pure-play water profile. Some thematic investors did acknowledge the de-carbonization benefit of

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Peoples' gas pipe replacements as a qualifying factor for potential investment; however, others view the elimination of the gas exposure via a spin or sale as the quickest solution to re-capture its clean energy status.

- 4. More bearish investors see WTRG un-deserving of a premium P/E multiple,** given their view of the Peoples Gas acquisition as a strategic misstep that may require time to recover. Despite the discount to AWK, they view WTRG's 23-24x P/E on 2022E as not fully capturing the execution and strategic risks, especially versus high-growth, premium electric utilities like Wisconsin Energy (WEC, Sell) or Xcel Energy (XEL, Neutral).

**Our \$51, 12-month price target (unchanged)** is based on a SOTP approach, with 35x/22x P/E applied to our 2021 water/gas utility EPS estimates, respectively. Our valuation reflects a 30.6x blended P/E, below our AWK target multiple of 37x, with the relative discount still warranted given WTRG's water/gas business mix.

**Downside risks to our call include:** 1) PA regulation turns less constructive, which impacts earnings growth potential given the bulk of WTRG's earnings are derived from the state's water/gas operations, 2) the proposed DELCORA municipal water system acquisition fails to receive necessary approvals for completion, which could impact the longer-term water rate base growth outlook barring replacement with other municipal acquisitions, and 3) longer-term growth concerns about the gas utility segment further compresses WTRG's valuation, both on an absolute basis and relative to pure-play water utilities.

<b>WTRG</b>	12m Price Target: <b>\$51.00</b>	Price: <b>\$44.50</b>	Upside: <b>14.6%</b>
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Buy <b>CL</b>		GS Forecast				
Market cap: \$11.3bn Enterprise value: \$16.9bn 3m ADTV: \$53.4mn United States Americas Utilities M&A Rank: 3 Americas Conviction List			<b>12/19</b>	<b>12/20E</b>	<b>12/21E</b>	<b>12/22E</b>
		Revenue (\$ mn)	889.7	1,571.7	1,995.4	2,113.5
		EBITDA (\$ mn)	521.4	777.5	1,047.8	1,122.3
		EBIT (\$ mn)	360.8	525.4	755.5	800.4
		EPS (\$)	1.47	1.55	1.66	1.80
		P/E (X)	27.6	28.7	26.7	24.8
		EV/EBITDA (X)	19.1	21.4	17.1	16.4
		FCF yield (%)	(2.4)	(1.7)	(1.8)	(0.2)
		Dividend yield (%)	2.2	2.2	2.3	2.5
		Net debt/EBITDA (X)	2.3	7.2	6.0	6.1
			<b>6/20</b>	<b>9/20E</b>	<b>12/20E</b>	<b>3/21E</b>
EPS (\$)		0.29	0.22	0.44	0.69	

Source: Company data, Goldman Sachs Research estimates, FactSet. Price as of 23 Oct 2020 close.

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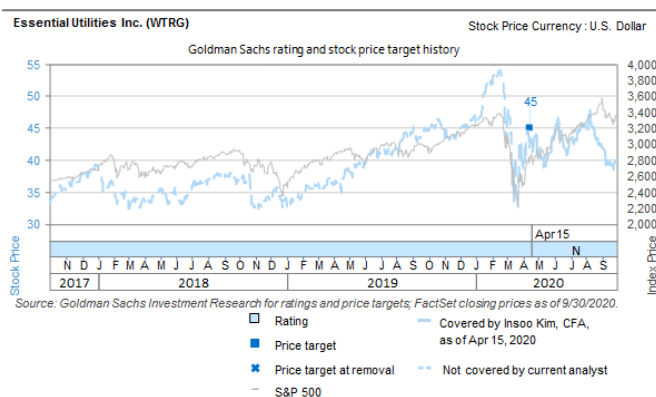
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